June 30, 2016

LORICA | INVESTMENT COUNSEL INC.

Focused Fixed Income

Market Highlights

In market terms, Q2 can be divided into three periods: (i) pre-May payroll report, (ii) post-May payroll report and pre-Brexit vote, and (iii) post-Brexit vote. (i) The quarter started with investors believing that the Fed may actually follow through with as much as two rate hikes in 2016 – US and Canadian yields rose for most of April. (ii) Following the April FOMC meeting, it became apparent that Janet Yellen was losing confidence in the ability of the Fed to raise rates. May's very weak payroll report (the weakest since September 2010), coupled with the weakness and uncertainty in Europe was seen as confirmation that no increases was the appropriate view – US yields were volatile, but ultimately fell during the period; Canadian yields fell for the entire duration of the period. (iii) Initially US and Canadian yields rose, as the "Remain" outcome appeared to be the more likely and was slowly priced into the market. However, with the "Leave" victory, bond yields once again turned down, reaching new lows in the process.

For the quarter, the Universe Index returned a lofty 2.62%, with 1.77% of the return coming in June. Long-end returns were exceptional at 5.48%, with 3.73% of the return coming in June. The mid and short areas were a distant 2nd and 3rd, returning 2.37% and 0.65% respectively. The flattening of the Canadian yield curve has been dramatic, with 30-year yields falling nearly 30 bps in the quarter while 2-year yields were virtually unchanged. Notably, long-term Real Return Bond yields fell by just under 20 bps over the same period, implying that inflation expectations only declined by about 10 bps. The decline of real yields was due largely to the translation of falling European yields (which were responding to European economic weakness, ECB intervention and the Brexit vote) across global sovereign bond markets.

The US bond market benefitted from its status as a safe haven, and having an appreciating currency, while offering a substantial yield pick-up over other high quality sovereign issuers. In typical fashion, the Canadian bond market benefitted from its status as liquid alternative to the US bond market. Canadas are also a relatively attractive proposition for investors looking for high quality debt, given its weakened currency and yield pick-up of 115 bps over German Bunds.

Despite the attraction of the domestic market, Canadian issuers sought to capitalize on the advantageous financing conditions and relative strength of foreign markets by launching new issues outside of Canada. $9 Billion of provincial and $32 Billion of Canadian corporate debt were issued outside of Canada during Q2, principally in the US and Europe. As a result, domestic corporate issuance by Canadian issuers was only $20 Billion, the lowest for Q2 in the last 5 years.

Portfolio Activity

On the back of steepening of the provincial credit curve we took the opportunity to add exposure to low coupon, western provincial and Quebec debt via a reduction of shorter-dated eastern provincial and Ontario debt which had outperformed. Additionally, the portfolio adjusted its subordinated bank positioning to take advantage of attractive relative value opportunities within the space. The portfolio's overall credit quality, yield curve and duration bias were maintained.

What Worked In The Quarter

The portfolio's corporate exposure (overweight relative to the index on both a market value and duration weighted basis) was concentrated in shorter-dated , higher yielding issues in corporate sectors which were top performers: insurance, pipelines, auto and media debt. Also benefitting the portfolio was the bull steepening of the credit curve which resulted in short, mid and long-term corporate yield spreads tightening by 10, 9 and 3 bps respectively.

What Didn't Work In The Quarter

Relative to the index, the portfolio was more conservatively structured with a shorter-duration and an overweight in the 5-year area of the yield curve in lieu of long bonds. For the quarter 2, 5, 10 and 30 year yields fell by 2, 11 and 26 and 29 bps respectively.

Outlook & Strategy

The portfolio has been positioned for improving economic fundamentals that would lead to eventual Fed rate increases. However, consistent with the Fed's actions, not necessarily its word(s), we believe global events (the uncertainty surrounding Brexit, the EU and ECB) and Fed inclinations have conspired to take prospective hikes off the table for the remainder of this year. There is very little room for the front end to go lower, although the BoJ and ECB have lead the way for negative rates if the Fed so desires. However, the back-end can still be pulled lower alongside foreign yields, which have been managed lower by aggressive monetary policy. With fundamentals suggesting higher yields, it still makes sense, in our view, to hold well below index duration (the Universe Index is now at a record 7.8 years). Notwithstanding, we will still look to take advantage of yield volatility.

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